

## Supreme Court of Texas Rules Installation of Faulty Product Not Covered by Standard CGL Policy

In *U.S. Metals, Inc. v. Liberty Mutual Group, Inc.*, No. 14-0753, 2015 Tex. LEXIS 1081 (Tex. Dec. 4, 2015) the Supreme Court of Texas ruled that installation of a faulty component does not cause physical injury to the machinery onto which it is installed, even when removal of the faulty component causes damage during the repair process. Therefore, claims for damage arising from the incorporation of a faulty component are not covered under a standard commercial general liability insurance policy unless the property at issue cannot be restored to use.

### Factual and Procedural Background

ExxonMobil Corp. (Exxon) purchased 350 custom-made, stainless steel, weld-neck flanges from U.S. Metals, Inc. (insured) for use in its Baytown, Texas, and Baton Rouge, La., refineries. The flanges were welded to the pipes that they joined. After installation and during initial testing Exxon discovered that the flanges leaked and did not meet ASTI specifications. As such, the faulty flanges presented a risk for fires and explosion. To avoid this risk, Exxon elected to replace the faulty flanges. As the flanges were welded into place, Exxon had to shut down its refineries and cut out the flanges in order to replace them. Thus, replacement of the flanges also damaged or destroyed the gaskets and required that new insulation and coatings be applied.

Exxon sued the insured for \$6,345,824.00, representing the cost of replacing the defective flanges, and for \$16,656,000.00, representing the lost use of the refineries during the replacement process. Ultimately, the parties settled for \$2,200,000.00 and the insured sought indemnification from its commercial general liability insurer, Liberty Mutual Group, Inc. (insurer) for the amount paid. The insurer denied coverage, arguing that damage to the flanges was not covered under Exclusion K, as "Property Damage to Your Product." The insurer argued that Exclusion M, regarding "Damage to Impaired Property or Property not Physically Injured" also applied.<sup>1</sup> In response, insured sued in federal district court to determine its right to a defense and indemnity under the policy. The federal district court granted summary judgment in favor of insurer and insured appealed.

The Fifth Circuit concluded that no controlling Texas case law determined whether the terms "physical injury" or "replacement," as used in the cited exclusions, were ambiguous. The Fifth Circuit further noted that no controlling Texas case law defined these terms. Rather than make an "Erie" guess, the Fifth Circuit presented these issues to the Texas Supreme Court on certified questions.

### The Court's Rulings

After first concluding that the operative terms of the policy were unambiguous, the Texas Supreme Court distilled the certified questions into two primary inquiries: 1) is property physically injured simply by the incorporation of a faulty component with no tangible manifestation of injury; and 2) is property restored to use by replacing a faulty component when property must be altered, damaged, and repaired in the process? Stated differently, the court noted that "the existence and extent of coverage depends on whether ExxonMobil's property was (1) physically injured or (2) restored to use by replacing the flanges."

Insured contended the faulty flanges damaged Exxon's property as the function and value of the Exxon property was diminished due to the increased risk of danger of fire and explosion. The court agreed that property can be "injured" by the incorporation of faulty components because its function or value is diminished. However, the court refused to characterize such intangible damages "physical injury." The court concluded that, "the best reading of the standard form CGL policy text is that the term 'physical injury' requires tangible, manifest harm and does not result



Gregory S. Hudson

**Member**

ghudson@cozen.com  
Phone: (832) 214-3909  
Fax: (832) 214-3905

**Related Practice Areas**

- Insurance Coverage

merely upon the installation of a defective component in a product or system.” In reaching this decision, the court noted, and rejected, the so-called “incorporation theory” which would hold that property suffers a “physical injury” when a defective component is incorporated. The court noted that only two of 12 state high courts had adopted the “incorporation theory” while the remainder rejected this position. The court acknowledged the perverse aspect of the ruling in that, had Exxon negligently failed to test the flanges, thereby resulting in an explosion or fire, there likely would have been a covered “physical injury.”

U.S. Metals next argued that covered “physical injury” existed because the act of replacing the defective flanges caused physical damage to Exxon’s property. Specifically, the removal of welded flanges caused damage to pipes, gaskets and coatings that then had to be repaired or replaced as part of the replacement process. The court held that such damages were excluded by Exclusion M, as the Exxon property could be restored to use by “replacement” of the defective flanges. The court noted that the term “replacement” was not limited to only those replacements that did not affect or alter the property as part of the replacement process. The court also stated that incorporating such a limitation into the policy language would not make sense, as coverage would then turn on the details of the replacement process, rather than whether property could be restored to use. However, the sub-components that were destroyed in the replacement of the flanges (gaskets, insulation, and coating) were expressly covered as “property damage” as those components were destroyed during the replacement process and could not be restored to use.

## Conclusion

*U.S. Metals* brings Texas case law regarding incorporation of defective component parts into the majority view on the subject. The court’s opinion emphasizes the need to carefully review the language in a particular policy, as the Texas Supreme Court carefully applied its holding to the language of the CGL policy at issue. In doing so, the court noted but did not address a significant underlying concern in the construction industry. *Amicus* briefs filed by both the construction industry and the insurance industry articulated policy concerns about the ability and efficacy of insurance to manage the risks created when defective products or work threaten an entire project and necessitate significant repair costs and loss of use. The court noted these concerns, but declined to opine on this issue, as the court focused on the language of the policy at issue. As such, both policyholders and insurers should be aware of such risks and concerns when writing and purchasing policies.

---

**To discuss any questions you may have regarding the issues addressed in this Alert, or how they may apply to your particular circumstances, please contact Gregory S. Hudson at (832) 214-3909 or [ghudson@cozen.com](mailto:ghudson@cozen.com) or Adam C. Gutmann at (832) 214-3919 or [agutmann@cozen.com](mailto:agutmann@cozen.com).**

---

<sup>1</sup> Subparagraph K excluded “‘property damage’ to ‘your product’ arising out of it or any part of it”, and Subparagraph M excluded, “[p]roperty damage’ to ‘impaired property’ or property that has not been physically injured, arising out of .. [a] defect, deficiency, inadequacy or dangerous condition in ‘your product’”. “Your product” was defined as “[a]ny goods or products ... sold ... by [Insured]”. “Impaired Property” was defined as, “tangible property, other than ‘your product’ ..., that cannot be used or is less useful because: a. It incorporates ‘your product’ ... that is known or thought to be defective, deficient, inadequate or dangerous; or b. You have failed to fulfill the terms of a contract or agreement; if such property can be restored to use by the repair, replacement, adjustment or removal of ‘your product’ ... or your fulfilling the terms of the contract or agreement.”